6000 STATE ADJUSTMENTS

Once federal net income has been determined, state adjustments are made to revise federal income to the amount allowable under California law. The most common state adjustments are discussed in this section. Because of differences in the way that taxpayers compute "net income *before* state adjustments" however, state adjustments may include virtually any kind of adjustment that the tax return preparer considers appropriate in order to arrive at the bottom line California income. For example, net income before state adjustments will often reflect "pro-forma" Form 1120s that include unitary members that were not included in the consolidated return filed for federal purposes (such as subsidiaries owned less than 80%). In other cases, net income before state adjustments will include only the income from entities that were actually included in the consolidated return as filed. The taxpayer will then make a state adjustment to include the income from unitary foreign subsidiaries and less-than-80%-owned subsidiaries. Both methods of reporting the subsidiaries' income will result in the correct bottom line, but the differences in the way that the income is reported makes it impossible to develop a definitive checklist of state adjustments. Auditors will need to carefully analyze the state adjustments in conjunction with their analysis of the income base in order to fully understand what is being reported to California.

Not only should the auditor thoroughly review all material state adjustments, but the auditor should also look out for state adjustments that the taxpayer failed to report. In order to identify potential adjustments, the auditor will need to be familiar with the areas of the law in which federal/state differences exist.

Reviewed: December 2002

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6005 AMORTIZATION OF INTANGIBLES

For federal purposes, IRC §197 entitles taxpayers to amortize certain intangible property over a 15-year period. Intangibles, which are eligible for this treatment, are defined in the statute, and include such property as goodwill, going-concern value, patents, licenses, and covenants not to compete. Although this provision generally applies to property acquired after August 10, 1993, taxpayers may elect to have the provisions apply to property acquired after July 25, 1991 (Temporary Treas. Reg. 1.197-1T; Sections 13261(a) and (g) of the Revenue Reconciliation Act of 1993 (P.L. 103-66)). If eligible assets were acquired in years that have already been filed, then federal amended returns will be necessary in order reflect IRC §197 treatment from the date of the asset acquisition.

California has adopted IRC §197 for taxable years beginning on or after January 1, 1994 (R&TC §24355.5). Although California also applies these rules to property acquired after August 10, 1993 (and to property acquired between July 25, 1991 and August 10, 1993 if such treatment was elected for federal purposes), IRC §197 treatment will not be allowed for any taxable year beginning before 1/1/94. Therefore, taxpayers will be under the old rules for years prior to 1994, and will switch to IRC §197 treatment beginning in 1994 (R&TC §24355.5(c)). (Under the pre-§197 rules, intangibles were only amortized if a limited useful life could be demonstrated with reasonable accuracy. No amortization or depreciation deduction was allowed with respect to goodwill (Treas. Reg. 1.167(a)-3).)

Example
A calendar year taxpayer acquires goodwill of $10 million on January 1, 1993, and makes the retroactive election to amortize it over 15 years. For federal purposes, the goodwill will be amortized at a rate of $666,667 per year for 15 years, beginning in 1993 ($10 million / 15).

For California purposes, no amortization is allowed for 1993. At January 1, 1994, the goodwill still has a basis of $10 million, and has 14 years remaining out of the 15-year life. Therefore, beginning in 1994, the taxpayer will deduct $714,286 per year for 14 years ($10 million / 14).

In 1993, the taxpayer will have a positive state adjustment of $666,667. For each year from 1994 through 2008, the taxpayer will have a negative state adjustment of $47,619.

The federal/state differences are only timing differences. As with any other issue that only involves the timing of a deduction, auditors should use judgement in deciding whether to make adjustments.

Reviewed: December 2002

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6010 ADR DEPRECIATION

Congress adopted the ADR class life system to provide for a safe-harbor useful life. The ADR system assigns a class life (mid-range life) for each class of assets. Each class of assets (other than land improvements and buildings) is also given an asset depreciation range of 20% above or below the class life. Although for federal purposes a taxpayer could elect to use the lower or higher range life for depreciation purposes, California conforms only to the mid-range class life. (Rev.Proc. 83-35; CCR §24349(l).)

If a taxpayer uses the 20% lower range life for federal purposes, then a state adjustment is required to adjust depreciation to the amount allowable for California purposes. Reasonable adjustments made by the taxpayer should be accepted. If no adjustment has been made, and the amount of the adjustment would be material, then the auditor should request the taxpayer to recompute depreciation using mid-range class lives. The taxpayer should also be allowed to recompute additional depreciation for California if the 20% higher range life has been used.

If the taxpayer has used the 20% lower range, and will not recompute depreciation for California purposes, an adjustment to a mid-range life can be approximated by:

Disallowing 20% of the depreciation taken by class life in each year; and
Amortizing the 20% disallowance for each year over a period that is one-year less than the mid-range class life. The amortization should begin the year after the 20% disallowance.

Following is an example of this computation:

Asset Class	**Description**	**--- Depreciation Reported ---**		
		1st Year	**2nd Year**	**3rd Year**
0.11	Office Furniture	40,000	50,000	60,000
10.0	Mining Equipment	320,000	400,000	480,000
33.4	Assets used in the manufacture of steel	140,000	175,000	210,000

The asset depreciation range of classes 0.11 and 10.0 is 8, 10 and 12 years. The asset depreciation range of class 33.4 is 12, 15 and 18 years. The taxpayer has used the lower range lives.

The first step is to combine the depreciation of asset classes within the same range. Then, 20% of the depreciation is disallowed in each year, and amortized over subsequent years.

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Asset Class	**--- Depreciation Reported ---**		
	1st Year	**2nd Year**	**3rd Year**
0.11	40,000	50,000	60,000
10.0	320,000	400,000	480,000
Total depreciation in asset range	360,000	450,000	540,000
	X 20%	X 20%	X 20%
Amount disallowed	72,000	90,000	108,000
Amortize over 9 yrs (mid-range - 1):			
72,000 / 9		(8,000)	(8,000)
90,000 / 9			(9,000)
Net adjustment to 10 year mid-range	72,000	82,000	91,000

Asset Class	**----- Depreciation Reported ---**		
	1st Year	**2nd Year**	**3rd Year**
33.4	140,000	175,000	210,000
	X 20%	X 20%	X 20%
Amount disallowed	28,000	35,000	42,000
Amortize over 14 yrs (mid-range-1):			
28,000 / 14		(2,000)	(2,000)
35,000 / 14			(2,500)
Net adjustment to 15 year mid-range	28,000	33,000	37,500
Total Adjustment (10 yr + 15 yr)	100,000	115,000	128,500

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6015 ACRS OR MACRS DEPRECIATION

California has not adopted the federal depreciation methods known as Accelerated Cost Recovery System (ACRS) or Modified Accelerated Cost Recovery System (MACRS). If those systems are used for federal purposes, state adjustments are required to adjust depreciation to the amount allowable under California law.

For federal purposes, ACRS must be used to compute depreciation for most tangible depreciable property placed in service after 1980 and before 1987. Under ACRS, the cost of property is recovered over 3, 5, 10, 15, 18 or 19 years, depending on the type of property and the year it was placed in service. The amount of the depreciation deduction is determined through use of tables found in Proposed Treas. Reg. §1.168-2.

Federal law requires the use of MACRS for most tangible depreciable property placed in service after December 31, 1986. MACRS extended the ACRS useful lives to 3, 5, 7, 10, 15, 20, 27.5 and 31.5 years. The amount of depreciation is determined using the applicable depreciation method, the applicable period and the applicable convention. Tables computing the deduction may be found in Rev. Proc. 87-57.

The specific rules for both ACRS and MACRS are complex, and should be researched if additional information is necessary.

R&TC §24349(b)(4) provides that, for California purposes, taxpayers may use any consistent method of depreciation as long the method does not result in more depreciation during the first 2/3 of the useful life than would result through use of the double declining balance method. Under this test, ACRS or MACRS would be an allowable method for California for 3-year ACRS/MACRS property, which also has a 3-year mid-range ADR life. Most other classes of ACRS/MACRS property would not meet this test.

If the taxpayer has not made a state adjustment to place ACRS or MACRS on an acceptable state depreciation method, the auditor should request the taxpayer to recompute California depreciation. In determining whether the taxpayer's recomputation is reasonable, the auditor should be aware that use of the safe-harbor ADR mid-range lives may only be elected on a timely filed return for the year that the assets are placed in service (CCR §24349(l)(1)(C)). If no election was made, then the useful life is dependent upon the facts and circumstances. Facts to take into account may include the useful life of assets for financial reporting purposes, and the taxpayer's asset replacement and disposition history.

Since depreciation allowable under generally accepted accounting principles is usually allowable for California as well, the auditor may adjust federal ACRS or MACRS depreciation to reflect book

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depreciation if the taxpayer does not recompute depreciation under an allowable California method. (But there may be situations where book depreciation would not be acceptable. For example, if a corporation is acquired when the fair market value of its assets exceeds the book value, the acquiring corporation may step-up the asset values for book purposes, and accrue additional depreciation on the stepped-up amounts. This additional depreciation would not be deductible for California. See MATM 7110 for more information regarding this issue.) The adjustment to substitute book depreciation for federal depreciation may be made by reversing the taxpayer's M-1 adjustments related to depreciation. Alternatively, the auditor may review the taxpayer's AMT depreciation calculations to determine whether depreciation computed under the AMT methods can be accepted as a reasonable California depreciation deduction. (See MATM 8520 for a summary of the AMT depreciation methods.)

Corporate Partners and S Corporations:

A corporate partner's distributive share of partnership depreciation may reflect MACRS. Revenue and Taxation Code §17858, added by Sec. 55.5 of A.B. 802 (Stats. 1989, Ch. 1352), provides:

For purposes of this part and Part II (commencing with R&TC §23001) any election relating to the computation of depreciation shall be made by the partnership and each partner shall take into account his or her distributive share of the amount computed in accordance with that election.

Section 165 of that same bill provides that §55.5 of the act is declaratory of existing law and shall apply to taxable years beginning on or after January 1, 1987.

Therefore, for partnership taxable years beginning on or after January 1, 1987, a corporate partner is not required (or allowed) to recompute its distributive share of partnership income where the partnership properly elected the MACRS method of depreciation.

Pursuant to R&TC §23802(f)(1), S Corporations must compute depreciation in accordance with the rules set forth in the California Personal Income Tax Law. These rules include use of the MACRS method.

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6020 DEPRECIATION – FOREIGN CORPORATIONS

Depreciation laws in foreign countries may vary considerably from those of California. In addition to allowing different methods of depreciation, some countries may allow depreciation to be computed on a basis other than historical cost (i.e.,. market value). Depreciation deductions of foreign operations in a combined report should therefore be reviewed for reasonableness. Regulation 25106.5-10 provides that the profit and loss statements of foreign branches and corporations shall be adjusted to conform to California tax accounting standards, and this includes California law with respect to depreciation. In accordance with CCR §25106.5-10(b)(3)(C), however, no such adjustments shall be required unless they are material in nature.

U.S. parents are required to report depreciation of foreign branches and affiliates on a U.S. accounting basis for purposes of financial statements prepared in accordance with generally accepted accounting principles, and also for purposes of Federal Form 5471 (Information Return of U.S. Persons With Respect to Certain Foreign Corporations). In the case of foreign parents, the notes to the foreign financial statements may disclose information regarding the method of depreciation used.

The assets of foreign corporations in a combined group may be depreciated using any method of depreciation otherwise acceptable for California, including accelerated depreciation. In accordance with the normal rules for depreciation, accelerated depreciation methods will generally only be allowed when such methods are used for California purposes from the date that the depreciable asset is acquired. When an existing foreign corporation becomes a member of the combined group however, its depreciation has not generally been computed for California purposes in the past. Therefore, the new member may opt to use accelerated methods for existing assets as well as for newly acquired assets. The amount of accelerated depreciation on existing assets must be computed *as if* the accelerated method had been used from the time that the assets were acquired. Alternatively, if the taxpayer does not want to recompute prior years, and therefore elects to apply accelerated methods only to current year additions, they may do so. When combining a foreign corporation for the first time, the auditor should offer the taxpayer (in writing) an opportunity to elect an acceptable California accelerated depreciation method.

Occasionally, taxpayers will try to convert their foreign depreciation to an allowable California method through use of estimates or ratios (such as the ratio of foreign assets to domestic assets). Such adjustments should not be allowed unless the auditor determines them to be reasonable approximations of the actual depreciation allowances (see *Appeal of PPG Industries, Inc*., Cal. St. Bd. of Equal., August 31, 1995).

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6025 DEPRECIATION RECAPTURE

California conformed to the federal depreciation recapture provisions for taxable years beginning on or after January 1, 1987 (R&TC §24903; R&TC §24990 for taxable years beginning on or after January 1, 1988). Prior to 1987, California had not adopted depreciation recapture rules. In many cases, characterization of income as ordinary recapture income rather than as capital gain will not have a tax effect. In certain situations however, this can be a material issue. The situations that have been identified are as follows:

Limitation on capital losses. For taxable years beginning on or after January 1, 1990, taxpayers may only deduct capital losses to the extent that they have capital gains (MATM 6040). Gain from the sale of a capital asset that has been characterized, as ordinary depreciation recapture income will not free up capital losses.

Liquidations falling under the transitional relief rules: Pursuant to P.L. 99-514, §633(c)(1), liquidations and stock acquisitions qualifying under IRC §336 - IRC §338 were generally nontaxable if they were subject to a binding contract entered into on or prior to August 1, 1986, and if the liquidation or acquisition was completed by January 1, 1988. In addition, P.L. 99-514, §633(d) extended the transitional relief to January 1, 1989 for certain small corporations. Pursuant to IRC § 1245(a)(1) and IRC §1250(a)(1) (to which California conforms), the recapture provisions override these nonrecognition provisions. Therefore, recapture income is recognized with respect to transactions in taxable years beginning on or after January 1, 1987, which would otherwise be nontaxable under the transitional rules.

Although the recapture income is reported for both state and federal purposes, the auditor should be alert to the fact that the amount of recapture income will seldom be the same due to state and federal depreciation differences. Since federal depreciation methods are generally more accelerated than state methods, the recapture amount will usually be higher for federal purposes. For cases in which depreciation recapture will produce a tax effect, the taxpayer's workpapers computing the recapture adjustment should be requested to verify that their calculation is correct for state purposes.

Reviewed: December 2002

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6030 DEDUCTIBLE DIVIDENDS (R&TC §24402)

Prior to 1990, dividends received from corporations subject to the Franchise Tax or Corporation Income Tax were deductible to the extent paid from earnings previously taxed under the Bank and Corporation Tax Law. The intent of this provision is to avoid double taxation of corporation income.

For taxable years beginning on or after 1990, R&TC §24402 was revised to allow a deduction for only the following portion of dividends paid from previously taxed earnings:

100% if received from a more than 50% owned corporation;

80% if received from a corporation owned at least 20%, but not more than 50%;

70% if received from a corporation owned less than 20%.

The deductible percentages used by the taxpayer should be compared to those shown on the deductible dividends website available on-line. If information for a particular dividend payor is not in the book, you may call the Deductible Dividend Desk in Sacramento for the deductible percentage ((916) 845-4138* *

Caution: The deductible percentages shown on the website represent 100% of the portion of the dividends paid from previously taxed income. For taxable years beginning on or after 1990, don't forget to make an additional adjustment of 70% or 80% if the payor corporation is not more than 50% owned. Following is an example of the computations:

Example
The taxpayer received a dividend of $100,000 in 1991 from Corp Y. The taxpayer's ownership percentage in Corp Y was 5%.

Total dividend received	100,000
X deductible percentage from on-line resources	3.50%
Portion of dividend declared from previously taxed income:	3,500
X 70% adjustment	70%
Deduction allowed under R&TC §24402	2,450

NOTE: ((* * *)) = Indicates confidential and/or proprietary information that has been deleted.

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6032 INTERCOMPANY DIVIDENDS (R&TC §25106)

R&TC Section 25106 provides that intercompany dividends paid out of earnings from the combined unitary business are eliminated from the income of the recipient corporation. This section deals with the computations of the R&TC §25106 elimination. For a discussion of issues related to deemed intercompany dividends (IRC §1248 dividends) arising from the sale of a subsidiary, see MATM 6036.

When reviewing intercompany dividend eliminations, the auditor should verify that the distributions were paid from unitary business earnings. To the extent that the distributions exceed the earnings and profits of the payor, or to the extent that they are paid from pre-affiliation or nonbusiness earnings, such distributions are not eliminated under R&TC §25106 (See *Willamette Industries, Inc. v Franchise Tax Board*, 34 Cal.App.4th 1396A). The auditor must also keep in mind that adjustments to the taxpayer's method of filing may effect the dividends eligible for elimination. For example, if a subsidiary is determined to be non-unitary and is decombined at audit, dividends received from that subsidiary may not be eliminated under R&TC §25106 (although a R&TC §24402 deduction may be appropriate - see MATM 6030).

A distribution by a corporation to its shareholders is a dividend to the extent that it is paid out of current earnings and profits, then from accumulated earnings and profits in the reverse order of accumulation. (For years prior to 1991, R&TC §24495 defined the term "dividend." Effective for taxable years beginning on or after January 1, 1991, R&TC §24451 conformed to the IRC §316 definition.) Earnings and profits can vary tremendously from net income for state purposes, particularly since earnings and profits are decreased by federal and state income taxes. Therefore, even though a dividend may not exceed the net income of the payor corporation, it may exceed the earnings and profits. It is also important to note that earnings and profits are calculated on a separate company basis. Therefore, although a subsidiary that incurs losses on a separate basis may be apportioned a large share of the combined business income of the unitary group, its earnings and profits will still reflect losses. (See *Appeal of Young's Market Company*, Cal. St. Bd. of Equal., November 19, 1986.) A detailed discussion of how to compute earnings and profits is in Chapter 11, Water's-Edge Manual.

Example
(Distribution exceeding earnings & profits)
Corporation P and unitary subsidiary S filed a combined report for the year in which S was formed. S's net income computed on a separate basis was $10,000; its apportioned share of the unitary business income was $50,000. S paid income taxes of $4,000. S distributed $9,000 to its parent during the taxable year. Although S's net income exceeded the amount of the distribution, S's earnings and profits were only $6,000 ($10,000 income - $4,000 taxes). Therefore, only $6,000 of the distribution is considered a dividend subject to elimination under R&TC §25106. The remaining $3,000 will first be applied to reduce the parent's basis in the stock of S; and once the basis is

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reduced to zero, any remaining amount will be treated as gain from the sale or exchange of property (such gain is not subject to R&TC §25106 elimination). See MATM 5260 for more detail concerning treatment of intercompany distributions in excess of earnings and profits and stock basis.

Once the auditor has determined that the distribution is indeed a dividend, the auditor must take this concept one step further and determine whether the dividends were "paid out of the income of the unitary business."

IMPORTANT: Since dividends are paid out of earnings and profits and not out of income, this statutory wording should be interpreted to mean that the dividends must be paid out of the earnings and profits that correlate with the unitary business income (*Rosemary Properties, Inc. v. McColgan*, 29 Cal2d 677). To the extent that the dividends are paid from earnings attributable to nonbusiness or pre-affiliation income, they may not be eliminated under R&TC §25106.

Example
(Dividend paid out of nonbusiness income)
Corporation P owned 100% of the stock of unitary Subsidiary S. In the current year, S had net earnings and profits of $80,000 comprised of business earnings of $20,000 and earnings attributable to a nonbusiness activity of $60,000. At year-end, S paid a dividend of $10,000 to P.

Since 25% of S's current year earnings was attributable to business activities ($20,000/$80,000), Corporation P would be able to eliminate $2,500 (25% of the dividend) under R&TC §25106. The remaining $7,500 of the dividend is business income to P because the S stock was a unitary business asset of P at the time that the dividend was paid (see MATM 4020), but it would not be subject to R&TC §25106 elimination. The $7,500 income may, however, be subject to a R&TC §24402 deduction.

If the dividend had been paid out of earnings and profits accumulated in prior years, he same process would be applied to determine the portion of the earnings attributable to business activities in each prior year (starting with the most recent year and working backwards).

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6034 DIVIDENDS FROM INSURANCE COMPANIES (R&TC §24410)

On December 21, 2000, the Court of Appeal in *Ceridian v. FTB*, (2001) 85 CalApp4th 875 (as modified, 86 CalApp.4th 383) held that the R&TC section 24410 insurance dividend deduction is unconstitutional. R&TC Section 24410 provides for the deduction of part of the dividends paid by an 80% owned insurance subsidiary that was subject to the California gross premiums tax to a parent corporation commercially domiciled in California. The Court found that R&TC Section 24410(a) violates the US Constitution commerce clause by limiting the deduction to entities commercially domiciled in California. The Court also found that R&TC Section 24410(b), the formula to compute the amount of the deduction, violated the commerce clause because it limited the deduction for entities earning income outside the state.

A statute that is declared unconstitutional is void and ceases to operate, see *Kopp v. Fair Political Practices Commission* (1995) 11 Cal4th 607, citing with approval, *Jawish v. Molet* (1952) 86 A.2d.96. R&TC section 19393 provides that if a deduction, credit, or exclusion is determined to be invalid or discriminatory under the constitution, the tax for taxpayers who received the benefit of the deduction is to be recomputed by disallowing the deduction. However, the court in *Ceridian* held that section 19393 only applies if all taxpayers who took the deduction for a particular tax year can be treated similarly.

The court considered three potential remedies: making assessments against taxpayers that benefited from the deduction, allowing refunds to taxpayers disadvantaged by the deduction, or a combination of the two. The court held that the only remedy available in this case was to give Ceridian Corporation a refund because the years in issue were so old that the SOL had expired for assessing and collecting additional tax from Ceridian's competitors who had benefited from the deduction.

For tax years' ending before December 1, 1997, the statute of limitations for issuing assessments has already expired for some taxpayers, therefore, it is not possible to treat all taxpayers comparably by disallowing the R&TC Section 24410 deductions. Therefore, in accordance with the holding in *Ceridian*, taxpayers will be allowed to take a 100% dividend deduction for dividends received from an 80% owned insurance subsidiary regardless of the commercial domicile of the parent or where the insurance company is operating. Refunds will be allowed if claims are, or have been, filed within the statute of limitations.

For tax years ending on or after December 1, 1997, the statute of limitations for issuing assessments is open for all taxpayers, therefore, R&TC section 19393 is applicable and the R&TC section 24410 dividend deduction should be disallowed for all taxpayers.

Department Policy

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1. For tax years ending <u>on or after</u> December 1, 1997, the department will disallow all R&TC section 24410 deductions. To the extent that a taxpayer added back to earned income expenses related to the 24410 deductions because the insurance company dividends were not in the measure of tax as provided by R&TC section 24425, that state adjustment should be reversed.

2. For tax years ending <u>prior to</u> December 1, 1997, all dividends received from an 80 percent owned insurance subsidiary are deductible. We will apply R&TC section 24425 (if material) to deny expenses to earned income not in the measure of tax.

The following explanations may be used in the AIP and/or in the NPA to explain the adjustment:

- The Revenue and Taxation Code section 24410 deduction is disallowed in accordance with the Court of Appeal decision in *Ceridian Corporation v. Franchise Tax Board* (2001) 85 Cal.App.4th 875 (as modified, 86 Cal.App.4th 383). The Court of Appeal held that the R&TC section 24410 deduction, which allowed a deduction for dividends received from certain insurance companies, discriminated against interstate commerce in violation of the United States Constitution. The Court of Appeal also held that R&TC section 24410 could not be reformed.

- A statute that is declared to be unconstitutional is invalid and unenforceable. (See *Kopp v. Fair Political Practices Commission* (1995) 11 Cal.4th 607 citing, with approval, *Jawish v. Molet* (1952) 86 A.2d 96.) Because R&TC section 24410 is invalid and unenforceable, the deduction is not available. R&TC section 19393 provides that the proper remedy in such circumstances is to disallow the deduction to those taxpayers that benefited from the deduction.

Another paragraph should be added if we are reversing the original return R&TC section 24425 adjustment. If we are unable to determine whether or not a R&TC section 24425 deduction was made on the original return, we should include the following paragraph in the AIPS and/or NPA:

- R&TC section 24425 disallows expenses attributable to income not included in the measure of tax. We have attempted to identify any R&TC section 24425 adjustment related to the R&TC section 24410 dividend deduction on your original return. If you have previously made an adjustment under R&TC section 24425 and we failed to identify and reverse the adjustment, you should protest this notice or file an amended return, and identify where the adjustment was shown on the original return and the amount of the adjustment.

FTB staff may be asked the following questions concerning Ceridian:

1. What is the impact of the Court of Appeal decision in Ceridian?
   Answer: R&TC section 24410 is invalid and unenforceable for all years.

Taxpayers that are similarly situated to *Ceridian* are members of the class of taxpayers disadvantaged by the deduction and are entitled to the same relief that was granted to *Ceridian*.

2. What taxpayers are eligible for relief consistent with the Court of Appeal decision in *Ceridian*?
Answer: Taxpayers that received dividends from 80% or more owned insurance subsidiaries in years where the statute of limitations for making new assessments has run, but who were denied the deduction under the unconstitutional limitations of R&TC section 24410.

3. Why are dividends received from insurance subsidiaries owned less than 80% not deductible?
Answer: A deduction was never allowed for such dividends under R&TC section 24410, so taxpayers that were denied the deduction on that basis are not within the remedial class of taxpayers under *Ceridian*. No taxpayer was benefited or harmed by this statutory limitation.

4. Why is there an abrupt change from full dividend deduction for taxable years ending prior to December 1, 1997 to no dividend deduction for years ending December 1, 1997 and later?
Answer: The determination of the appropriate remedy for an unconstitutional provision requires treating similarly situated taxpayers the same. R&TC Section 19393 provides that when a statute is declared unconstitutional, the way to accomplish this is to deny the deduction to those who benefited from the deduction. However, as the *Ceridian* court held, this remedy couldn't be applied to taxpayers for taxable years beyond the four-year statute of limitations, because other similarly situated taxpayers have already taken the R&TC section 24410 deduction and the time to issue Notices of Proposed Assessment denying them the deduction has passed. Therefore, the only way to place all similarly situated taxpayers in the same position is to allow a 100% deduction for dividends received from 80% owned insurance companies during these years.

See also MATM 3085 and MATM 5190 for additional issues concerning insurance companies.

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6036 DIVIDEND GROSS-UPS, SUBPART F INCOME, AND IRC §1248 DIVIDENDS

The Federal 1120 returns contain adjustments to dividend income reported on Schedule C that may not be applicable for state purposes. Some adjustments are:

Dividend Gross-Ups - For federal purposes, dividends received from foreign affiliates are "grossed up" to include income taxes paid on the dividends to foreign countries. The taxpayer is then allowed to take a foreign tax credit for the grossed-up amount. California has no such provision and this income should be eliminated. A review of Schedule C of the Federal Form 1120, or Form 1118 (foreign tax credit form) may identify any dividend gross-ups.

Subpart F Income - For federal purposes, dividend income may include Subpart F income. In general, certain types of income earned by controlled foreign corporations (as defined in IRC §957) are taxed to the U.S. shareholder as a deemed dividend under Subpart F of the Internal Revenue Code (IRC §951 - IRC §964). To the extent that actual distributions are made out of earnings that have been previously taxed to the shareholder under Subpart F, the distributions are excluded from the recipient's income.

Example
A CFC has subpart F income of $8 in Year 1. The $8 is treated for federal purposes as deemed dividend income to the U.S. shareholder in Year 1. In Year 2, the CFC pays an actual dividend of $10. For federal purposes, dividends are considered to be distributed first from previously taxed income (in contrast to the normal LIFO ordering rule for dividends). Therefore, $8 of the $10 dividend is considered paid from the previously taxed income, and $2 is paid from non-subpart F earnings. Only $2 of the distribution will be shown as a taxable dividend on the federal return for Year 2.

Since California does not conform to the Subpart F provisions, the income is not taxed for State purposes until it is actually repatriated to the U.S. shareholder. Therefore, state adjustments will be necessary (1) to eliminate the subpart F deemed dividend income, and (2) to include the actual dividend distributions in income when paid.

Example
Assume the same facts as in Example 1. For California purposes, the taxpayer should have made a state adjustment in Year 1 to reverse the $8 federal subpart F deemed dividend income. In Year 2, another state adjustment will be necessary to increase dividend income reported for federal purposes by $8. If the CFC is a member of the combined report, then the $10 dividend may be subject to elimination under R&TC §25106. If the dividend was not paid out of unitary earnings and profits, then the dividend would be taxable for California purposes.

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The presence of Subpart F income is usually shown on the federal Schedule C or Form 5471. In the year that the actual distributions are made however, the Schedule C will only identify the portion of the dividend that is taxable for federal purposes. There should be a Schedule M-1 adjustment for the difference between the actual distribution and the federal taxable amount, but occasionally there will be no M-1 adjustment, or the adjustment will be buried within another M-1 item. Consequently, the federal return is not a reliable source for verifying the amount of the actual distribution. If properly prepared, Schedule 5 of the Form 5471 should detail actual distributions and whether they are considered to be from previously taxed subpart F income. The best way to determine the actual amount of the dividends received is usually through the taxpayer's pre-consolidation books of account. Chapter 9, Water's-Edge Manual and Chapter 11, Water's-Edge Manual describes this issue in more detail, and provides examples of how to determine the amount of the actual distributions.

1248 Dividends
When a U.S. shareholder sells stock in a controlled foreign corporation in which they meet certain ownership requirements, the gain recognized on the sale may be considered a deemed dividend for federal purposes (subject to certain earnings & profits limitations). Pursuant to R&TC §24903 and R&TC §24990, California conformed to this provision during a window period beginning with taxable years beginning on or after January 1, 1987. Our conformity was terminated by R&TC §24990.7 for transactions occurring after August 20, 1990, in taxable years beginning on or after January 1, 1990. Therefore, for sales of stock reported on the installment method, payments received during the window period would be subject to IRC §1248 treatment even though the actual sale took place prior to January 1, 1987.

During the window period, the deemed dividends may be subject to R&TC §25106 elimination if the foreign subsidiary was a member of the combined report (MATM 6032). Transactions occurring before and after the window period are treated as gains on the sale of stock for California purposes. Adjustments may be necessary to reflect the correct amount of gain based upon the California cost basis of the stock (see MATM 6095 for a discussion of these adjustments and other issues related to sales of subsidiaries).

If a member of the combined report has a recently acquired foreign subsidiary, and if the acquisition date was outside the window period, auditors should review the taxpayer's pre-consolidation books or ledger summaries to look for subsequent distributions made by the foreign corporation to its new owners. If the stock sale was treated as a deemed distribution for federal purposes, a portion of the foreign corporation's earnings and profits will be considered to be "previously taxed." Actual distributions made to the new owner in subsequent years will not be subject to federal tax to the extent that they are paid from the previously taxed earnings and profits (even though the E&P was previously taxed to the seller, not the buyer!) Consequently, foreign dividends identified on the new owner's federal Schedule C or Form 5471 may be understated or omitted altogether. The book/federal tax difference may be disclosed on the Schedule M-1, but is not always apparent. For

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California purposes, the earnings and profits are not considered to be previously taxed so the dividends may be taxable. Furthermore, since the E&P was incurred prior to acquisition by the new owners, it will not be subject to R&TC §25106 intercompany elimination (although a foreign dividend deduction may apply if the new owner has elected water's-edge).

A review of Schedule C of the Federal Form 1120 may identify whether any of these items are included in federal dividend income. The Schedules M-1 and Forms 5471 should also indicate the existence of dividend gross-ups and Subpart F income. The auditor will then need to determine whether appropriate state adjustments have been made.

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6040 CAPITAL LOSSES

Prior to 1990, California did not conform to the federal limitation on capital losses. For federal purposes, capital losses can only be deducted to the extent of capital gains. Any capital losses that are not deductible in the year of the loss may be carried back three years, and carried forward five years (IRC §1211 - IRC § 1212). In the year in which a capital loss was incurred, the taxpayer would therefore have a negative state adjustment for the amount of the loss that was not allowed for federal purposes. Positive state adjustments would be made in the years in which the taxpayer utilized the federal capital loss carrybacks and carryovers.

Effective for taxable years beginning on or after January 1, 1990, R&TC §24990 states that IRC §1201 - IRC §1296 are applicable law for determining capital gains and losses. Included in these sections are the provisions relating to the federal capital loss limitation. For California purposes however, unused capital losses may only be carried forward; no carrybacks are allowed. (R&TC §24990 - R&TC §24990.5).

Although California now conforms to the capital loss limitation, federal/state differences will still arise. Federal/state basis differences will affect both the amount of capital loss, and the amount of capital gain to which the capital loss deduction will be limited. (For example, assume a taxpayer has a $35,000 capital loss for both federal and state purposes. For federal purposes, the taxpayer has a $40,000 capital gain, and may therefore deduct the entire capital loss. Due to basis differences, the gain is only $30,000 for California. The loss will be limited to $30,000, and the taxpayer will have a $5,000 capital loss carryover for California.)

If material gain or loss transactions are reported on the Federal Schedule D or Form 4797, the federal and state computations should be reviewed to ensure that appropriate federal/state basis differences were taken into account. The amount of any capital loss carryover should also be reviewed to verify that it properly reflects the California amount.

Also, included in these law sections to which California now conforms are the federal procedures for netting gains and losses in order to determine the capital loss limitation. Capital losses are deductible only to the extent of capital gains, and any excess losses may be carried over and applied against capital gains in each of the five succeeding taxable years.

On July 13, 1999 CCR § 25106.5 went final. Regulation 25106.5-2 provides for the intrastate apportionment of business gains or losses from the sale or exchange of capital assets, IRC §1231 property and involuntary conversions prior to the netting provisions. Those gain/loss items are then netted at the entity level after intrastate apportionment with nonbusiness gains or losses. The regulation is retroactive.

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6050 CHARITABLE CONTRIBUTIONS

Contributions deductible for state and federal purposes may differ significantly. When reviewing the contributions deduction for state purposes, be aware of the following:

The federal limitation on the deduction for contributions is generally 10% of net income, although members of a consolidated return are limited to 5% of adjusted consolidated taxable income. The California limitation is 5% (10% for taxable years beginning on or after 1/1/96), and applies on a combined basis (R&TC §24358). In addition, California further adjusts the contribution deduction to take into account the effect of nonbusiness items on the income limitation (this is termed the "contributions adjustment" -- see MATM 4070). The contributions adjustment is calculated on Schedule R-6 of the Form 100. Rather than separately compute (1) the general 5% income limitation as a state adjustment, and (2) the contributions adjustment on Schedule R-6, taxpayers will often use the Schedule R-6 to reflect the overall adjustments. By analyzing the Schedule R-6 computation, as well as what has ultimately been deducted on the California return (federal deduction ± state adjustments ± contributions adjustment), auditors can determine whether the bottom line results are correct.

In addition to differences in federal and state net income, there are differences in the adjustments to income that are required for purposes of computing the limitation. For federal purposes, net income is adjusted for net operating loss deductions, and other special deductions not applicable to California. For California, adjustments are made to add back the R&TC §24402 dividends received deduction, deductions for built-in gains and passive investment income, and certain other deductions.

Federal law allows for a five-year carryover of excess contributions. For taxable years beginning prior to 1/1/96, California has no carryover. However, R&TC §24358(3)(b) was revised and now provides that IRC §170(d)(2), relating to carryovers of excess contributions, shall apply with respect to excess contributions made during taxable years beginning on or after 1/1/96.

California generally limits the contribution of appreciated property to the corporation's basis in the property (R&TC §24357.1). See MATM 6051 below for an exception with respect to qualified research contributions.

R&TC Section 24359 states that a charitable contribution means a contribution or gift to or for the use of a qualified recipient, created or organized in the United States or in any possession thereof. In computing combined unitary income, however, it is the Department's policy to allow contributions made by non-US corporations to non-US charitable organizations (provided that the foreign jurisdiction has not ruled that such beneficiary is not a qualified charitable organization). (Audit Program Report 86-4)

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R&TC Section 24425 provides for the disallowance of expenses incurred to earn income that is not included in the measure of tax. The most common type of income that is not included in the measure of tax is deductible dividend income. Because the dividend income is not being taxed, R&TC §24425 provides that the expenses incurred to earn the dividends should not be deducted. Expenses relating indirectly to this type of income may include charitable contributions, interest expense, officer's compensation, office rent and overhead, etc. If material, a portion of these expenses should be allocated to the deductible dividends. The methodology used to allocate the expenses will vary depending upon the facts and circumstances, so you will have to select an allocation method that is reasonable for the taxpayer's specific situation. For example, charitable contributions generally relate indirectly to all of a taxpayer's income. Therefore, it would be reasonable to allocate the contributions to deductible dividends based on the ratio of deductible dividends over the taxpayer's total receipts (the SBE and courts have supported this approach). However, if the taxpayer suggests a different allocation method, be sure to evaluate that method to determine whether it is reasonable. If the primary position the auditor is taking is that the dividends should not be deductible in the first place, the auditor is still required to develop whether material expenses attributable to that dividend income should be disallowed as an alternative position.

Certain other differences exist with respect to the rules for certain types of contributions. If a contribution is material, the auditor should verify whether California conforms to the specific rules pertaining to that contribution.

A review of the Schedule M-1 should reveal whether the federal contribution deduction includes carryover amounts or contributions of appreciated property.

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6051 QUALIFIED RESEARCH CONTRIBUTIONS

Many computer companies donate systems to colleges and avail themselves of R&TC §24357.8. If they meet all of the requirements, they are entitled to increase their deduction by 50% of the difference between fair market value and cost (limited to twice the basis of the property).

The principle requirements under this provision are as follows:

The contribution must be of tangible personal property as described in paragraph (1) of IRC 1221 -- generally property included in the inventory of the donor.

The contributed property must be scientific equipment or apparatus; and substantially all of the use by the donee must be for research or experimentation or for research training in physical, applied, or biological sciences, or for instructional purposes. (Use of the property for instructional purposes does not qualify for federal purposes.)

The property must be contributed within two years after construction. California does not have the federal requirement that the taxpayer must construct the property.

The donee must be an institution of higher education *in California*. Unlike federal, California does not include tax-exempt scientific organizations as eligible donees.

The donee must be the original user of the property.

The college or university cannot transfer the property for money, other property or services.

A written statement must be obtained from the donee representing that the use and disposition of the property will be in accordance with R&TC §24357.8.

The auditor should verify that deductions for qualified research contributions do not include contributions to non-California donees. If such contributions are noted, adjustments should be made to limit the deduction to the cost basis of the contributed property.

If the contribution to California institutions is material, the auditor should review the required donee statements for compliance with R&TC §24357.8. The taxpayer's method of establishing the fair market value of the property should also be reviewed for reasonableness.

Prior to 1992, any portion of the contribution deduction that exceeds the adjusted basis of the donated property is a tax preference item (see MATM 8530). Auditors should review the AMT computation to verify that this preference has been reported correctly.

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6054 CREDIT FOR CLINICAL TESTING EXPENSES

For years 1987 through 1992, California allowed a credit for the cost of clinical testing and development of drugs for rare diseases (R&TC §23609.5, MATM 9040). Pursuant to R&TC §24440, the taxpayer must reduce any deduction that would otherwise be allowable by the amount of the credit. Although federal law provides for a similar credit, differences between the federal and state computation of the credit will result in different limitations on the deduction of clinical testing expenses. When this credit is reported, state adjustments will be necessary to account for these differences.

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6055 DONATED AGRICULTURAL PRODUCTS CREDIT

For years 1989 through 1991, a credit is allowed for agricultural products that are donated to nonprofit organizations (R&TC §23608, MATM 9050). The taxpayer must reduce any deduction that would otherwise be allowed by the amount of the credit claimed. Since there is no comparable federal credit, a state adjustment will be required to add back the deduction.

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6056 FUEL TAX CREDIT

Under federal law, a taxpayer may apply for either a refundable tax credit (IRC §34) or a refund (IRC §6420- IRC §21) for federal excise taxes on gasoline used for farm purposes or specific other off-highway business purposes. Since the excise tax is either refunded or allowed as a credit, it is not allowed as a deduction for federal purposes.

The state fuel tax is also refundable through the State Controller. The refunds are includable in income, and will offset the fuel tax deductions for state purposes. Some taxpayers deduct the fuel tax for California purposes as a state adjustment similar to the adjustment for the jobs tax credit (MATM 6057). In such cases, the auditor should ensure that the state adjustment is offset with an adjustment to include the fuel tax refunds in income.

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6057 JOBS/ZONE WAGE TAX CREDITS

For federal purposes, if a taxpayer claims a jobs tax credit, their deduction for wages and salaries must be reduced by the amount of the credit (IRC §280C(a)). Although California does have a jobs tax credit (R&TC §23621, MATM 9070), the provisions differ from the federal provisions. The principal difference is that California does not reduce the taxpayer's deduction for wages and salaries by the credit. In all circumstances, the deduction for payroll and salary expense is allowable in its entirety for state purposes. If a federal jobs tax credit has been taken, there should be a Schedule M-1 adjustment for the payroll expense reduction. For California purposes, a state adjustment should be made to reverse the M-1 adjustment.

California law also provides credits for wages paid to qualified individuals in designated Enterprise Zones (R&TC §23622; MATM 9062), Program Areas (R&TC §23623; MATM 9062), Local Agency Military Base Recovery Areas (R&TC §23646; MATM 9084), and the Los Angeles Revitalization Zone (R&TC §23623.5, R&TC §23625; MATM 9092 - MATM 9094). If any of these credits are claimed, the deduction for wages paid to such individuals must be reduced by the amount of the credit generated in that taxable year. Since there are no comparable credits in Federal law, a state adjustment will result. For further details regarding economic development area tax incentives, refer to the Economic Development Areas Audit Manual.

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6058 RIDESHARING TAX CREDIT

For taxable years beginning on or after January 1, 1989, employers are allowed a California tax credit for participating in certain rideshare activities (R&TC §23605, MATM 9150). If a credit is taken, no deduction is allowed for the rideshare costs. Since there is no comparable credit under federal law, a state adjustment will be necessary to add back the rideshare expenses. In addition, the California basis of any ridesharing vehicle must be reduced by the amount of the corresponding credit. This will contribute to the overall federal/state depreciation difference.

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6060 EMPLOYEE STOCK OPTION PLAN TAX CREDIT

For compensation paid or accrued before 1987, an employer was allowed a federal tax credit for contributions to a tax credit employee stock ownership plan (commonly known as a PAYSOP). No deduction was allowed for contributions that were subject to the credit. California did not conform to these provisions, so the contributions continued to be deductible for state purposes. If a federal credit has been taken, there will usually be a Schedule M-1 adjustment for the related deduction. For California purposes, the federal Schedule M-1 adjustment should be reversed. An analysis of taxpayer's Federal Form 8007 (Federal tax credit employee stock ownership plan) and its related workpapers should also identify the allowable deduction for California purposes.

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6065 INTEREST ON GOVERNMENT BONDS

For California Franchise Tax purposes, gross income includes all interest received from federal, state, municipal or other bonds (R&TC §24272).

The U.S. Constitution prohibits a direct tax on interest income from U.S. obligations; therefore such interest is not taxable for California Income Tax purposes. The constitutional prohibition does not apply to the California Franchise Tax however, because it is not considered a direct tax (although it is based on income, it is actually a tax on the privilege of doing business). Since U.S. government interest is taxable for federal purposes, no state adjustment for such interest should be necessary for taxpayers subject to the franchise tax. Any state adjustments made by the taxpayer to back out the interest income should be reversed.

Interest on state and municipal obligations is generally not taxable for federal purposes. Such interest is only exempt for California Income Tax purposes if the obligations are on California or its political subdivisions. Interest on obligations of other states or foreign countries are subject to the California Income Tax. All state and municipal interest is subject to the franchise tax. Schedule M-l will disclose whether the taxpayer has exempt interest for federal purposes. If such interest exists, the auditor should verify that state adjustments have been made to add back the interest to the extent necessary for franchise or income tax purposes.

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6070 INTERCOMPANY PROFIT IN INVENTORY

Intercompany profit in inventory occurs when sales of products are made between members of a combined group. Profit from intercompany sales is generally not recognized until the goods are sold to an outside party. Therefore, to the extent that goods that had been subject to an intercompany sale remain in the inventory of the unitary purchaser, the profits from the intercompany transaction should not be recognized.

The department's policy, as set forth in Publication 1061, Guidelines for Corporations *Filing a Combined Report*, is that the intercompany profit in inventory should be eliminated from combined income (MATM 5260). Correspondingly, the profit in inventory should also be eliminated from the beginning and ending inventories for purposes of computing cost of goods sold, as well as for property factor purposes. (See MATM 7173 for property factor adjustments). The income adjustment for any one year will be the difference between the intercompany profit in the beginning inventory and the ending inventory of each affiliate which has intercompany purchases. As a general rule, a negative adjustment to income will be necessary if inventories increase from year to year; while a positive adjustment will result if inventories decrease. Examples of both cases are as follows:

	Increasing Inventory	Decreasing Inventory
Profit in Inventory - 01/01/xx	$ 100	$ 100
Profit in Inventory - 12/31/xx	<u>150</u>	<u>50</u>
Adjustment to Eliminate Intercompany Profit in Inventory	(50)	50

If the taxpayer has made an adjustment for intercompany profits in inventory, the computation should be reviewed to ensure that the amount is reasonable, that the taxpayer is applying the adjustment consistently from year to year, and that the factors have also been adjusted.

Under GAAP, intercompany profits in inventory are eliminated for book purposes. A reconciliation of Schedule M-1 book income to the financial statements (MATM 5130) should identify whether the book elimination adjustments have been picked up for federal purposes. If the Schedules M-1 reveal that the federal intercompany profits in inventory differ from the book amounts, then the auditor should determine whether a state adjustment is necessary.

For federal purposes, intercompany profits on sales of products are deferred rather than eliminated. (See MATM 5260 for a discussion of the federal deferral rules.) Neither method recognizes intercompany income in the year of the sale. The primary difference is that under the elimination method, the buyer takes the related seller's basis in the product so the gain is effectively recognized

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only when the product is ultimately sold to a third party. Under the federal deferral method, the buyer's basis is the consideration paid for the product. The deferred gain is recognized upon the occurrence of a "restoration event" such as a sale of the product to a third party or a disaffiliation of the buyer or seller. This distinction may create a federal/state difference when a restoration event other than a third party sale occurs. For federal purposes, the deferred intercompany profits would be restored into income, but no gain would be recognized for California. Federal/state differences may also occur when the taxpayer has intercompany profits in inventory with respect to entities that are not included in the consolidated Form 1120 (i.e., foreign entities).

Material issues may be created when inventory balances at the date of a water's-edge election include inventory purchased intercompany between foreign and domestic entities. See Chapter 17, Water's-Edge Manual for more discussion of this issue.

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6075 FOREIGN INVENTORY ADJUSTMENTS

Pursuant to R&TC §24701, California generally conforms to the federal rules for inventory valuations and methods (IRC §471 and IRC §472). In accordance with those rules, inventories are valued at either (1) cost or (2) lower of cost or market. For an inventory accounting method to be accepted under IRC §471, it must conform as nearly as possible to the best accounting practice in the trade, and it must clearly reflect income. Some of the inventory methods allowed for tax purposes are described in Treas. Reg. §1.471-5 through Treas. Reg. §1.471-11, and Treas. Reg. §1.472 (LIFO).

Both California and federal law allow the use of the Last-in First-out (LIFO) inventory method. California generally conforms to the IRC §472(c) requirement that the LIFO method will only be allowed for tax purposes if it is also used for financial statement purposes. Because LIFO is not an acceptable method in many foreign countries however, California will allow the use of LIFO for foreign operations even though the foreign inventories are computed on a FIFO basis for financial statement purposes (CCR §25106.5-10(b)(3)(B)(ii)).

Normally, the election to use LIFO must be made on the original return or on an amended return filed by the due date of the original return. This applies to foreign as well as domestic entities in the combined report. In cases where foreign corporations are combined for the first time at audit however, the taxpayer will be allowed to retroactively elect to use LIFO for valuation of the foreign corporation's inventory starting with the first year of combination.

Example
Audit combined the taxpayer on a worldwide basis for 1980 - 1989. All years are in litigation, appeals or protest. In 1996, the taxpayer now agrees that they are unitary on a worldwide basis. The taxpayer will be allowed to elect to use LIFO for inventory valuation starting in 1980.

Example
Assume the facts as in Example 1, except the taxpayer was previously audited for 1977 - 1979, and did not dispute the worldwide combination for those years. The years were closed without the use of LIFO inventory valuation. The taxpayer cannot use the LIFO method on a retroactive basis for any year. If the due date for the current year return has not passed, the taxpayer can elect to use LIFO for that year.

To verify the acceptability of the foreign inventory method, the following steps should be taken:

The auditor should determine the base of valuation for foreign inventories (i.e., cost, lower of cost or market, or another method). For some countries, the inventory balances themselves may not be adjusted to account for market fluctuations, but such fluctuations may be charged to reserve accounts. The financial statements will usually identify the inventory valuation used, and whether any

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reserves are used. Publications, which describe the accounting practices of the foreign parent's country, may also help to determine how inventory was valued -- see Exhibit J. If the valuation is not acceptable for California purposes and the difference is material, then adjustments to beginning/ending inventories and to the property factor should be considered. (But see CCR §25106.5-10 and MATM 5145 for criteria to consider before requiring a foreign corporation to conform its method of accounting to a California method.)

The auditor should determine the inventory method used to account for foreign inventories (i.e., FIFO, LIFO, etc.). The financial statements will usually identify the inventory methods used, and publications, which describe the accounting practices of the foreign parent's country, may provide additional information regarding those methods. If the inventory method is acceptable for California purposes, then the issue does not need to be pursued further. However, if the foreign corporations are being combined for the first time and the taxpayer wishes to elect an inventory method specifically for California worldwide reporting purposes, they should be given the opportunity to do so.

If the taxpayer wishes to convert to a LIFO inventory method for foreign inventories, the auditor should verify that the LIFO adjustments are correct. In the past, the department has required taxpayers to submit a CPA certification to support their LIFO values. This will no longer be required, although an auditor may still accept such a certification as one way for the taxpayer to meet their burden of proof regarding the LIFO valuations.

Rules for use of the LIFO method are provided in Treas. Reg. §1.472, and a description of LIFO is also contained in Chapter 17, Water's-Edge Manual. Although LIFO can be calculated based upon the quantity and cost of specific goods (e.g., unit method), most taxpayers use the "dollar-value" method:

For each pool of inventory, the cost for each item in the pool at the beginning of the first LIFO year will be aggregated to derive the base-year costs. The beginning inventory costs used for financial reporting purposes should generally be used. Because LIFO inventories are required to be stated at cost rather than at lower of cost or market, any previous write-downs of base-year inventory must be added back into income ratably over three years (IRC §472(d)).

For each LIFO year, the value of each pool of ending inventory must be determined using the cost that the inventory would have had in the base-year. The computational approaches available to restate ending inventory at base-year costs include the double-extension method, the index method, and the link-chain method. These methods are explained in Treas. Reg. 1.472-8.

The beginning and ending inventories (expressed in base-year costs) are compared. If the value has increased over the year, then the amount of the increase is multiplied by the ratio of current costs over base year costs to arrive at the value of the current year LIFO layer. If the value has decreased, then prior year LIFO layers are decreased (liquidated) accordingly.

Once inventory balances have been determined under the LIFO method, cost of goods sold must be recalculated. If financial statement net income was used as the base for California net income, the

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state adjustment should reflect the difference between cost of goods sold calculated for book and California tax purposes.

As discussed in CCR §25106.5-10 and MATM 5145, the department must consider the cost of compliance and materiality of the issue. For example, if a subsidiary operates solely within one foreign country and has a similar line of products, it may be reasonable to take a "short-cut" by treating all inventory in that country as one LIFO pool. On the other hand, the information needed to make LIFO computations is available in the ordinary course of the taxpayer's business, so estimations should not be accepted unless the auditor is comfortable that the estimate is a reasonable approximation of the actual numbers. For example, it is never reasonable to accept foreign LIFO valuations based on the ratio of domestic tax inventory to domestic book inventory.

When the inventory method used for California is different from the method used for book purposes, the auditor should verify that the correct inventory valuation has been included in the property factor. Book/tax differences may be revealed during the property factor reconciliation discussed in MATM 7110.

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6080 DEPLETION

For taxable years beginning on or after January 1, 1987 through December 31, 1992, California conformed to the federal rules for depletion, except with respect to percentage depletion for oil, gas and geothermal wells (R&TC §24831 - R&TC §24833). (For taxable years beginning on or after January 1, 1993, California repealed §24832 and §24833 and now conforms to federal depletion rules for oil, gas and geothermal wells.) The percentage depletion rates are listed in IRC §613. Prior to January 1, 1987, California's depletion rates differed from federal, and were listed in §24833. Another state/federal difference that existed prior to January 1, 1987 was California's limitation on the amount of percentage depletion on sulfur that could be deducted in any one year. This limitation was similar to the limitation on oil and gas that is discussed below.

Percentage depletion is a preference item for AMT purposes to the extent that it exceeds the basis of the property. See MATM 8530.

Oil, Gas & Geothermal Wells

Under federal law, percentage depletion is allowed for the following:

Regulated Natural gas
Natural gas sold under a fixed contract
Certain geothermal deposits
Certain independent producers and royalty owners subject to a 65%-of-taxable-income limitation.

For taxable years beginning on or after January 1, 1993, California follows the federal provisions for percentage depletion.

For taxable years beginning on or after January 1, 1987 through December 31, 1992, California does not restrict percentage depletion as provided under federal law, but provides for a depletion rate of 22% for oil, gas and geothermal wells. As long as the accumulated depletion does not exceed the adjusted basis of the property, the amount of depletion deductible in any year is limited only by the general 50%-of-net-income limitation (computed on a combined basis). Once basis is exceeded, however, an additional limitation will apply if the total depletion for all of the taxpayer's oil, gas and geothermal properties exceeds $1,500,000. In such a case, the depletion that would otherwise be allowable must be reduced by 125% of the amount by which the depletion allowance exceeds $1,500,000. Under this formula, if the accumulated depletion exceeds the cost basis and the current year depletion allowance is $7,500,000 or more, the depletion deduction for the current year will be phased out. The limitations on the depletion deduction must be computed for the combined group as a whole, not on a separate entity basis. (former §24833.)

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For years beginning prior to January 1, 1993, the auditor should verify that a state adjustment has been made to account for the state and federal depletion differences. If the state depletion deduction is material, the taxpayer's depletion workpapers should be reviewed to determine whether the limitation has been correctly applied.

Although California conforms to federal depletion provisions for years beginning on or after January 1, 1993, the auditor should be aware that the basis on which the cost depletion is calculated may differ. For example, if the original asset cost was $100 and federal cost depletion taken prior to 1993 was $80, a federal basis of $20 would remain. For California purposes, percentage depletion taken prior to 1993 might have been $90, leaving a California basis of $10. California cost depletion for 1993 should be based on $10.

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6085 INTANGIBLE DRILLING AND DEVELOPMENT COSTS

The California and federal laws are similar. For taxable years beginning prior to January 1, 1987, California did not conform to IRC 291(b), which only allowed a percentage of the intangible drilling costs (IDCs) to be currently deducted. Since the portion of the IDCs that was not currently deductible for federal purposes was allowed to be amortized over five years, this may result in a state/federal difference through 1991 (the five-year federal amortization period of IDCs capitalized in 1986 will end in 1991).

Another California-Federal difference involves geothermal wells. For federal purposes, IRC §263(c) allows taxpayers the option to currently expense IDCs for oil, gas and geothermal wells located within the United States. R&TC §24423 is substantially the same as IRC §263(c), but only applies to oil and gas wells. Therefore, California has no provision that would allow IDCs related to geothermal wells to be currently expensed.

For years beginning on or after January 1, 1987, neither Federal nor California permit expensing of IDC's relating to costs paid or incurred with respect to an oil, gas, or geothermal well located outside the United States.

Intangible drilling costs may be an item of tax preference for alternative minimum tax purposes. See MATM 8530 for more details.

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6086 TERTIARY INJECTANT EXPENSES

A "tertiary recovery method" means any method that is described in Section 212.78(c)(1) through (9) of the June 1979 Energy Regulations, 10 CFT 212.78 (1979). Very broadly, this entails injecting hydorcarbon gas into an oil or gas well to increase pressure for recovery. For federal purposes, tertiary injectant expenses are deductible in the year that the injections were made (IRC §193; §263(a)(1)(F)). California does not conform to the federal treatment. R&TC Section 24422 adopts similar language as IRC §263, except for §263(a)(1)(F). In addition, California does not have a similar provision as IRC §193. For California and financial reporting purposes, if tertiary costs enhance the recovery process, they are capitalized and amortized over the life of the reserve. If the tertiary costs do not enhance the recovery process, they will be expensed.

An examination of the federal Schedule M-1 should identify if tertiary costs have been capitalized for books but expensed for federal tax purposes. If so, then state adjustments will be required to reverse the deduction in the year of the injection and to allow amortization in subsequent years.

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6090 SAFE HARBOR LEASING

Between 1981 and 1983, former IRC §168(F)(8) provided a safe harbor election that guaranteed that certain transactions would be treated as leases rather than as financing arrangements, even though the transaction would not otherwise qualify as a lease. In effect, this provision permitted the transfer of depreciation benefits and investment tax credits between taxpayers. California never adopted the Safe Harbor Leasing provision, and continued to follow case law and pre-safe harbor IRS guidelines in determining whether a transaction should be treated as a lease. A discussion of federal requirements for safe harbor leases, and guidelines followed by California in determining whether a transaction qualifies as a lease, may be found in FTB Legal Ruling 419 (1981).

Even though the safe harbor rules no longer exist under current law, the rules still apply for federal purposes for the duration of leases that were entered into under a valid safe harbor election. Therefore, federal net income may still include income and deductions related to safe harbor leases. Following is an example of how the safe harbor leases are structured:

Example: Corporation X purchases new equipment with a 10-year life for $1,000,000. X "sells" the equipment to Corporation Y for $200,000 cash and an $800,000 15-year note. Y then "leases" the equipment to X for 15 years, for an amount that exactly offsets the debt service. The only money that changes hands on the transaction is the $200,000 payment from Y to X. At the end of the lease Y sells the asset to X for one dollar. As the deemed owner under former IRC §168(f) (8), Corporation Y is entitled to an investment tax credit and accelerated depreciation with respect to its "leased" asset. Corporation X has the benefit of a rental deduction.

Schedule M-1 should disclose whether any transactions are being reported under the safe harbor rules for federal purposes. If so, state adjustments are necessary to reverse the income and deductions related to the transaction. These adjustments may include the following:

If the taxpayer is the lessor, depreciation on the leased property and interest deductions related to the note should be added back into income. Rental income should be eliminated.

If the taxpayer is the lessee, rental expense should be added back into income, and interest income from the note should be eliminated. The lessee should be allowed a depreciation deduction for the property based upon original cost less the down payment received from the lessor.

For state purposes, some taxpayers have attempted to deduct or amortize the down payment made on the safe harbor lease transaction (the $200,000 payment in the above example). As discussed in Legal Ruling 419, this payment is for the purchase of federal tax benefits. Since the federal income taxes themselves are not deductible, neither is the safe harbor lease down payment. This deduction

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should be disallowed. Since the adjustment may be netted with other safe harbor lease items, it is important to analyze the taxpayer's adjustments to verify that they are proper.

Adjustments to the property factor of both the lessor and lessee will also be necessary -- see MATM 7205.

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6095 SALES OF SUBSIDIARIES

Since California law is significantly different from federal law with respect to investments in subsidiaries, material issues may be found in this area.

When a parent and subsidiary are members of a consolidated group, the parent's basis in the subsidiary's stock is treated as an investment account for federal purposes. Accordingly, it is increased by the net income of the subsidiary, and decreased by net losses and distributions out of earnings and profits (Treas. Reg. 1.1502-32). To the extent that the negative adjustments would otherwise reduce the parent's basis in their stock below zero, an "excess loss account" is established (Treas. Reg. 1.1502-32(e)). When the subsidiary is sold, gain or loss on the disposition of the stock is computed using the parent's basis net of any investment adjustments. The balance of any excess loss account is recaptured into the parent's income (Treas. Reg. 1.1502-19). California has no similar provisions. For state purposes, gain or loss on the sale of the stock of a combined subsidiary is computed using the parent's original cost basis (net of any distributions that constituted returns of capital). Because of this difference, the sale of a consolidated subsidiary will almost always result in a state adjustment.

Federal/state basis differences may also occur with respect to stock in foreign subsidiaries. For federal purposes, certain income of controlled foreign corporations (CFCs) is treated as a deemed dividend to the U.S. shareholder. Such income is termed "subpart F" income. The basis of the CFC is increased by the amount of subpart F income that has been taxed to the U.S. parent, and decreased by any distributions that have been repatriated out of previously taxed subpart F income. (IRC §951 - IRC §964, see also MATM 6036.) Since California does not conform to these rules, gain or loss from the sale of a foreign subsidiary is again computed using the cost basis of the stock.

For federal purposes, the gain on the sale of stock in a CFC may also be deemed dividend income to the U.S. shareholder (IRC §1248). California conformed to this provision during a window period from taxable years beginning on or after January 1, 1987 to transactions occurring on or before August 20, 1990 in taxable years beginning on or after January 1, 1990. Outside of that window period, IRC §1248 dividends are treated as gains on the sale of stock for California purposes, and are not subject to R&TC §25106 elimination of intercompany dividends (see MATM 6036).

Reviewing Schedules D and M-1 of the Form 1120 may identify stock transactions. Annual reports and SEC Form 10-Ks may also identify dispositions of subsidiaries. When a subsidiary has been disposed of during the audit period, the auditor should determine how the disposition was reported for state purposes. To ensure that original cost was used, the taxpayer's basis computations should be reviewed.

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6100 TAXES MEASURED BY INCOME OR PROFITS

No deduction is allowed for taxes on, or according to, or measured by income or profits paid or accrued within the taxable year (R&TC §24345). Since state, local and foreign income taxes are generally deductible for federal purposes, the auditor should analyze the deduction for taxes to insure that all taxes measured by income have been added back for state purposes.

For purposes of R&TC §24345, the term "income" refers to gross income. It is important to distinguish between gross income and gross receipts because a tax measured by gross receipts is deductible. Gross receipt is a term generally used to describe gross proceeds including a return of capital (cost of goods sold). In order to arrive at gross income, gross receipts are reduced by cost of goods sold. The determination of whether a tax is on or according to or measured by income must be made on a case-by-case basis by looking at the make-up of the specific tax imposed. Certain types of receipts, such as rents or income received for the performance of services, do not contain a return of capital element. In these cases, gross receipts are the same as gross income, and the tax on that income will be considered to be a non-deductible income tax. For further guidance in determining whether a tax is based on income, see *Appeal of Huntington Alloys*, Inc. Cal. St. Bd. of Equal., September 12, 1984; *Appeal of Charles and Mary Haubiel*, Cal. St. Bd. of Equal., May 15, 1974; *Beamer v. Franchise Tax Board*, (1977) 19 Cal.3d 467, 475; MCA inc. v. FTB (1981) 115 Cal.App.3d 185.

Federal Environmental Tax:
The federal environmental tax imposed by IRC §59A is deductible for federal purposes. The computation of this tax is based on federal alternative minimum taxable income (AMTI). Since AMTI is merely net income computed under different rules than those used for federal regular tax purposes, the environmental tax is a tax based on net income. The environmental tax is therefore not deductible for California purposes, and should be added back as a state adjustment.

Michigan Single Business Tax:
The state of Michigan imposes a tax known as the Single Business Tax (MSBT). For purposes of computing the tax base, employee compensation is added back to federal gross income. Since a labor component is generally included in cost of goods sold, adding back the compensation will result in an element of cost of goods sold being included in the tax base. The State Board of Equalization has ruled that if the tax base includes any element of return of capital, then the tax is measured by something other than gross income, and is therefore deductible (*Appeal of Dayton Hudson Corporation*, Cal. St. Bd. of Equal., February 3, 1994). In order to determine whether a corporation has a labor component in cost of goods sold, the auditor should look to the federal standards under IRC §263A. If the corporation has as little as $1 of labor cost of goods sold, the MSBT will be deductible. Furthermore, in the *Appeal of Kelly Service, Inc and Subsidiary Corporations*, Cal. St. Bd.

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Of Equal., May 8, 1997, the State Board of Equalization concluded that the MSBT makes no distinction between activities of a taxpayer when calculating the measure of tax. The State Board of Equalization found that the MSBT is deductible as provided by R&TC §24345(b), regardless of the specific components of the MSBT base of the taxpayer claiming the deduction.

Although not specifically addressed in the *Dayton Hudson* case, the MSBT computation also includes a depreciation add-back. To the extent that the depreciation would be a component of cost of goods sold under the IRC §263A standards, it appears that the same rationale may also apply.

Alternative Taxes or Hybrid Tax:
Some states have an alternative tax system under which a tax is calculated under two different bases (i.e., net income and net worth), and the larger of the two taxes is assessed. In such cases, the auditor must determine which method was ultimately used to compute the tax in each year. For years in which the tax was based upon net income, the tax is not deductible. A review of the other state tax return should identify the base used to calculate the tax.

Other states have a hybrid tax. An example is the franchise tax that Texas has imposed since 1991. Under the Texas franchise tax, tax is computed separately on net taxable capital and net taxable earned surplus. To the extent of the tax on net capital, the franchise tax imposed will always be characterized as a non-income tax. But, if the tax on earned surplus exceeds the tax on net capital, the excess is characterized as a tax on earned surplus (an income tax). Since Texas itself bifurcates its franchise tax into income and capital elements, the FTB has taken the position that the portion of the tax that is imposed on earned surplus is not deductible.

Severance Taxes:
Severance taxes levied on mineral production based on the value and/or quantity of production are deductible for California because they are not based upon realized income. In a letter to CCH dated October 5, 1981, the department took the position that the Federal Windfall Profits Tax is deductible. This tax was repealed in September 1988.

Foreign Taxes:
Because of the difficulties involved with determining the nature of some foreign taxes, rules specifically for foreign taxes have been set forth in CCR §24345-7. The regulation contains a presumption that foreign taxes are income taxes. The burden of proof rests upon the taxpayer to establish that a particular foreign tax was not based on net income. Some countries impose a "dual capacity tax," which is defined as a tax, which is all or in part an income tax, but which is also for receipt of a specific economic benefit. In order to deduct any portion of a dual capacity tax, the taxpayer must prove that the portion of the tax is not an income tax. Once the taxpayer has established that it has paid a dual capacity tax, then it must determine the amount of such tax by

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either facts and circumstances or application of the safe harbor formula. See MATM 7795 for detailed guidelines on this matter.

Audit Techniques:
All annual reports of U.S. companies disclose the amount of income taxes. If the taxpayer has classified taxes as income taxes for book purposes, they should generally be added back as a state adjustment. The following test may be made to determine whether the income tax add-back is reasonable in relation to the income taxes disclosed on the audited financial statements:

Income taxes per Annual Report		xxx
<u>Schedule M-1 adjustments:</u>		xxx
Add:	State, local or foreign income taxes deducted in return but not for book purposes	
Deduct:	Federal income taxes booked but not deducted in the return	(xxx)
	State, local or foreign income taxes booked but not deducted in the return	(xxx)
	Minimum amount required to be added back as a state adjustment:	xxx
Less:	Amount added back per return	(<u>xxx</u>)
	DIFFERENCE	xxx

IMPORTANT: Adjustments should *not* be proposed based solely upon the above reconciliation. The reconciliation is only a test to identify whether additional work is required.

If there is a material difference between the above amount and the amount added back into income, the auditor should make a thorough analysis of the taxes deducted on the return and the tax provision in the financial statement footnotes. Following are some sources of information regarding amounts of foreign and domestic taxes:

<u>supporting detail to Form 100 or 1120, lines:</u>
2 (cost of goods sold), 17 (taxes), and 26 (other deductions); Schedule M-1; Federal Form 5471 (Information Return of U.S. Persons with Respect to Foreign Corporations); and Federal Form 1118 (Computation of Foreign Tax Credit - Corporations).

Note: Federal Form 1118 will provide information regarding foreign taxes taken as a credit, but it is not necessarily determinative as to whether a tax is or is not an income tax. A tax that qualifies for the foreign tax credit is generally a tax measured by income (assuming that the taxpayer filed their Federal Form 1118 correctly). On the other hand, the fact that a tax is not reported on Federal Form 1118 does not indicate that the tax is not measured by income, because taxpayers may elect to deduct foreign income taxes for federal purposes rather than take a credit.

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Once the taxes paid to particular jurisdictions have been identified, information regarding the nature of the taxes imposed by the various jurisdictions may be found in large public libraries. A review of the tax returns filed with the other jurisdictions is also helpful in identifying the nature of the tax and the composition of the tax base.

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